

**CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY**

**FOR
PERMISSIBLE EQUITY FOR EMERGING EQUITY MARKETS**

May 14, 2007

This Policy is effective immediately upon adoption and supersedes all previous permissible equity for emerging equity markets policies.

I. PURPOSE

This document sets forth the investment policy ("the Policy") for the permitted standards and parameters for the inclusion of country markets permitted for investment. This policy applies to CalPERS' international equity and emerging markets equity portfolios. The policy is not applicable to corporate governance emerging market funds which are addressed in the Statement of Investment Policy for Corporate Governance Investments.

II. STRATEGIC OBJECTIVE

The strategic objective is to set minimum acceptable standards of investibility for emerging country equity markets to be permissible for investment by CalPERS to control risk and enhance return.

III. RESPONSIBILITIES

- A. The **System's Investment Committee** ("Investment Committee") is responsible for approving and amending the Policy.
- B. The **System's Investment Staff** ("the Staff") shall review written policies and procedures of the Managers concerning compliance with the Policy. The Staff shall monitor reports from the Managers and the System's custodian to ensure the equity markets program is in compliance with this Policy.
- C. The **General Pension Consultant** shall review each country equity market's comparison to the requirements of this Policy for the purposes of establishing which markets meet the minimum thresholds of acceptability in accordance with this Policy.
- D. The **External Managers** shall be delegated the responsibility of country market and stock selection in accordance with this Policy and their guidelines that shall require minimum stock selection standards and reporting requirements on how individual companies meet minimum acceptable standards, including the Global Sullivan Principles of

~~Corporate Social Responsibility and the International Labor Organization (ILO) Declaration on Fundamental Principles and Rights at Work.~~

~~IV. BENCHMARK~~

~~Not applicable.~~

~~V. MASTER LIST OF COUNTRIES~~

~~A. The master list of emerging country markets shall derive from those included in the country lists of the major emerging equity markets index providers.~~

~~B. Each country included for review must meet the World Bank definition of an emerging country based on its per capita GNI (Gross National Income). The World Bank revisits this per capita standard annually.~~

~~VI. FACTORS OF EVALUATION~~

~~A. The factors of evaluation shall include those that can be generalized to the entire country and those that pertain specifically to the public equity market within each country. The CalPERS Board reserves the right to add, remove, revise, or define factors in its sole discretion. Factors, known as the macro-factors, may be further sub-divided into sub-factors to better focus the full intent of the macro-factor.~~

~~B. Country Factors~~

~~1. **Political Stability:** Political stability, including progress towards the development of basic democratic institutions and principles, such as guaranteed elimination of human rights violations (such as torture), and a strong and impartial legal system, all of which are necessary to ensure political stability, support free market development, and attract and retain long-term sources of capital. This macro-factor shall include the following sub-factors:~~

~~a. **Civil Liberties:** The extent to which countries permit freedom of expression, association and organizational rights, rule of law and human rights, free trade unions and effective collective bargaining, personal autonomy and economic rights. A score of three (highest) means that a country has relatively good civil liberties and a score of one (lowest) means they are poor.~~

b. ~~Independent Judiciary and Legal Protection:~~ The extent to which countries have independent judiciaries, the degree to which or the absence of irregular payments made to the judiciary and the extent to which there is a trusted legal framework that honors contracts and clearly delineates ownership of and protects financial assets. A score of one (lowest) to three (highest) is used where the higher score indicates greater overall legal protection.

c. ~~Political Risk:~~ The extent to which there exists government stability, a high quality of socioeconomic conditions, and a positive investment profile. Toward these ends this sub-factor evaluates the extent of internal and external conflict, corruption, the military and religion in politics, law and order, ethnic tensions, democratic accountability and bureaucratic quality. A score of one (lowest) to three (highest) is used where the highest score means less overall political risk exists in that country.

2. Transparency: Financial transparency, including elements of a free press necessary for investors to have truthful, accurate and relevant information on the conditions in the countries and companies in which they are investing. This macro-factor shall include the following sub-factors:

a. ~~Freedom of the Press:~~ The structure of the news delivery system in a country and the laws and their promulgation with respect to their influence of the news, the degree of political influence and control, economic influences on the news and the degree to which there are violations against the media with respect to physical violations and censorship. A score of three means the press in a country is free and a score of one means it is not free.

b. ~~Accounting Standards:~~ The extent to which publicly traded companies in the country utilize either US GAAP (Generally Accepted Accounting Principles) or IAS (International Accounting Standards) in financial reporting, and whether the country is a member of the International Accounting Standards Council. A score of one to three is used where one means IAS or US GAAP standards are not used and three (highest) means either IAS or US GAAP is used for financial reporting.

c. ~~Monetary and Fiscal Transparency:~~ The extent to which governmental monetary and fiscal policies and implementation are publicly available in a clear and timely manner, in accordance with international standards. A score of one (lowest) to three (highest) is used where the higher score indicates the greatest transparency.

d. ~~Stock Exchange Listing Requirements:~~ This sub-factor evaluates the stringency of stock exchange listing requirements for public companies with respect to frequency of financial reporting, the requirement of annual independent audits and minimum financial viability. A score of three means the listing requirements are most stringent, and a score of one means they are the least stringent.

3. ~~Productive Labor Practices:~~ To facilitate economically-productive labor practices, markets shall be evaluated based on their ratification of and adherence to the International Labor Organization's principles, which cover labor rights and prohibitions on abusive labor practices, and the degree of effectiveness of implementation through relevant laws, enabling regulations and their degree of enforcement through the judiciary process. This macro-factor shall have the following sub-factors:

a. ~~The extent to which the country has ILO ratification for the eight core conventions. Each country will be graded on:~~

- | | |
|-----------------|-------------------------|
| 1) Ratified | 2) Pending ratification |
| 3) Not ratified | 4) Denounced |

b. ~~Quality of Enabling Legislation:~~ Countries shall be evaluated on whether laws exist that explicitly protect the right described in the ILO Convention, or portions of it, or whether laws exist that explicitly prohibit the Convention right, or portions of it. The objective is to evaluate fundamentally, how well the right described in the Convention is protected by the law. For each law, in addition to identifying if the law exists, any shortcomings in its adequacy or completeness with reference to the relevant ILO Convention shall be evaluated, along with information about the regulations that implement the relevant laws.

c. ~~Institutional Capacity:~~ The governmental administrative bodies with enforcement responsibility for enforcing labor law that exists at the national, regional and local level.

- d. ~~*Effectiveness of Implementation:*~~ The procedures that exist for enforcement and monitoring of enforcement of laws in the Convention areas and evidence that exists that these procedures are working effectively; the existence of a clear grievance process; evidence that workers or unions or both utilize this grievance process; the extent to which penalties provided for in the laws are levied; and the evidence that penalties have deterrence value.

The sub-factor scores total to a maximum of 40 points per country. The sub-factors are more heavily-weighted toward the quality of enabling legislation and the effectiveness of implementation. The *Productive Labor Practices* factor scores have been rescaled on a one (lowest) to three (highest) basis, where a score of three indicates the most effective labor practices.

C. ~~Market Factors~~

1. ~~*Market Liquidity and Volatility:*~~ This segment measures the ability to buy or sell assets in a country in a timely manner without adversely affecting security prices. Also included in this category is an analysis of each country's stock market return volatility, including currency risk. Sub-factors under consideration for this category are listed below.
- a. ~~*Market Capitalization:*~~ Market capitalization represents the overall size of a country's stock market. A score of one (lowest) to three (highest) is assigned, with higher scores reflecting a higher level of market capitalization (i.e., larger market).
- b. ~~*Change in Market Capitalization:*~~ This factor represents the growth of a country's stock market over the last five years. A score of one (lowest) to three (highest) is assigned, with higher scores reflecting a higher level of market capitalization growth.
- c. ~~*Average Monthly Trading Value:*~~ This factor represents the average dollar value of shares traded, relative to the size of each market (i.e., market capitalization). A score of one (lowest) to three (highest) is assigned, with higher scores reflecting a higher level of trading.

d. ~~Growth in Listed Companies:~~ This factor represents the number of companies in each country that are publicly traded and are listed on a local stock exchange and their growth over the last five years. A score of one (lowest) to three (highest) is assigned, with higher scores reflecting the growth of listed companies.

e. ~~Market Volatility (as measured by standard deviation):~~ This factor represents the level of return volatility (risk) over the last five years in each country's stock market, attributable to both currency volatility and local market volatility. A score of one (lowest) to three (highest) is assigned, with higher scores reflecting a lower level of volatility.

f. ~~Return/Risk Ratio:~~ This factor represents the percentage of total return achieved per percentage of risk in each market. This category was created so as not to penalize those markets that display a high level of positive volatility. A score of one (lowest) to three (highest) is assigned, with higher scores reflecting a higher return/risk ratio.

2. ~~Market Regulation/Legal System/Investor Protection:~~ This category analyzes a broad set of factors that together comprise a large portion of the investment climate within a country. This category attempts to identify the degree of legal protection for foreign investors within a country, as well as shareowner and creditors' rights. The following sub-factors are analyzed:

a. ~~Adequacy of Financial Regulation:~~ A score of one (lowest) to three (highest) is assigned, with higher scores reflecting greater financial regulatory and supervisory stringency.

b. ~~Bankruptcy/Creditors' Rights:~~ This segment reflects the adequacy of creditors' rights in each market, in the case of bankruptcy proceedings/reorganization. A score of one (lowest) to three (highest) is assigned, with higher scores reflecting a higher level of creditors' rights.

c. ~~Shareowners' Rights:~~ This segment reflects the Adequacy of shareowners rights in each market. A score of one (lowest) to three (highest) is assigned, with higher scores reflecting stronger regulations regarding shareowners' rights.

3. ~~**Capital Market Openness:**~~ Openness to foreign investment is a critical barometer of a government's commitment to free market policies. Markets are viable if they have the ability to attract and retain long-term sources of capital. Further, markets are evaluated based on the level of restriction imposed on foreign investors. The following sub-factors are evaluated:

a. ~~**Trade Policy:**~~ This sub-factor measures the degree to which there is oppressive government interference in free trade through deterrents such as trade barriers and punitive tariffs.

b. ~~**Foreign Investment:**~~ This sub-factor examines governmental barriers to the free flow of capital from foreign sources through the imposition of restrictions on foreign ownership of local assets, repatriation restrictions and unequal treatment of foreigners and locals under the law.

c. ~~**Banking and Finance:**~~ This sub-factor looks at undue government control of banks and financial institutions and measures such factors as government ownership of banks and allocation of credit and the degree of freedom financial institutions have to offer all types of financial services, securities and insurance policies. Protectionist banking regulations against foreigners are also evaluated.

d. ~~**Stock Market Foreign Ownership Restrictions:**~~ This sub-factor examines the extent to which the local stock market restricts share ownership of public companies by foreigners.

A score of one (lowest) to three (highest) is assigned, with higher scores reflecting a higher level of market openness.

4. ~~**Settlement Proficiency/Transaction Costs:**~~ Cost effective, efficient settlement of securities transactions is critical as the world moves to one-day settlement. This factor measures the degree of efficiency and the cost effectiveness of transacting in the markets included in this analysis.

a. ~~**Settlement Proficiency:**~~ This segment illustrates whether a country's trading and settlement is automated and measures the success of the market in settling transactions in a timely, efficient manner. A score of one (lowest) to three (highest) is

assigned, with higher scores reflecting an automated, efficient operational process.

b. Transaction Costs: This segment measures the costs associated with trading in a particular market and includes stamp taxes and duties, amount of dividends and income taxed, and capital gains taxes. High trading costs tax the returns and increase the hurdle rate of managers investing in these markets. Markets that impose a high level of taxes, or have a high level of trading costs, receive a low score. A score of one (lowest) to three (highest) is assigned, with higher scores reflecting a lower level of transaction costs. *Please note that transaction costs relating to market impact associated with liquidity are reflected in the first category: Market Liquidity/Volatility.*

VII. EVALUATION METHODOLOGY

A. Frequency of Evaluation — Annually

B. Source of Evaluation — Third party expert sources shall be used to evaluate macro-factors and sub-factors. These third party sources where possible shall be readily available public sources recognized as having expert insight into the macro factor or sub-factor subject to evaluation. Each source shall evaluate each country or market comparatively across the macro factor or sub-factor for which it is being utilized. In the event there is no public or readily available third party source, the CalPERS Board, in its sole discretion, may contract with a source, consultant or other vendor for a custom evaluation for CalPERS according to its specifications. If a custom evaluation is utilized, CalPERS shall make the evaluation available for public inspection. All third party sources utilized are subject to the review and approval of the CalPERS Board in its sole discretion. The CalPERS Board reserves the right to make changes in the third party sources from one annual evaluation period to the next without notice.

C. Aggregating the Individual Evaluations — The General Pension Consultant shall collect the third party source evaluations and shall aggregate them according to a three-point scale: three points for a superior evaluation, two points for an acceptable evaluation and one point for an unacceptable evaluation. Each sub-factor shall be scored according to this three point scale, and where necessary, rescaling the scoring methodology of the third party source. The sub-factors of each macro-factor shall be weighted to derive a score for the macro-factor of which the sub-factors are part. The macro-factors shall be weighted to derive a score for each country that also

shall be evaluated on a three point scale. The three point scale shall be calculated to a whole number for the 2005 evaluation, and shall be calculated to one decimal place beginning with the 2006 evaluation, for both sub-factors and macro-factors. At the country level, the calculation of scores shall be carried out to three decimal places and rounded to two decimal places for the 2005 evaluation, and shall be calculated to two decimal places and rounded to one decimal place beginning with the 2006 evaluation.

D. Weighting Scheme for Factors

1. The sub-factors, unless otherwise determined by the CalPERS Board, shall be equal-weighted, or weighted in accordance with the weights used by the third party source in the event one third party source is used for the evaluation of all sub-factors within a macro-factor.
2. The macro-factors shall be divided into Country Factors and Market Factors with country and market factors each receiving in aggregate a weight of 50% of a country market's total score. Within the country factors and market factors the macro-factors shall be equal-weighted.
3. The CalPERS Board reserves the right to modify the weighting of any macro-factor or sub-factor in its sole discretion from one annual evaluation period to the next.

E. Ranking and Scoring Thresholds of Permissibility

1. The CalPERS Board reserves the right to establish the threshold of minimum acceptability for a country market in its sole discretion and change it from one evaluation period to the next at its discretion. A country market currently shall receive a total weighted score of at least 2.00 on a three point scale for a determination of permissibility.
2. Scoring thresholds based on the three point scale outlined in Section VII. C. for the factors shall be established at levels that are reasonably comparable from one evaluation period to the next to determine the degree to which a country market is improving or deteriorating relative to the standards of evaluation set by the CalPERS Board, and shall be disclosed in the supporting tables for the sub-factors. In

~~the case where a new factor is introduced or is significantly modified the thresholds from one year to the next may not be comparable, but shall be reviewed and approved by the CalPERS Board.~~

~~3.The country markets shall be ranked from the highest score to the lowest score for the purposes of determining the threshold for permissibility.~~

~~4.For the purposes of this Policy, American Depositary Receipts and Global Depositary Receipts that are traded in approved markets are permissible provided that the issuer's home market, based on the country where it is headquartered, is permissible.~~

VIII. REPORTING PROCEDURES

~~A. Annually the General Pension Consultant shall prepare a report with the evaluations of the country markets in accordance with the Policy. This report shall include at a minimum:~~

~~1.This list of countries subject to evaluation and the index publishers used to develop that list.~~

~~2.A description of the evaluation methodology.~~

~~3.The list of factors on which country markets are evaluated with their descriptions or definitions.~~

~~4.The weighting scheme for macro and sub-factors.~~

~~5.The scores for each country market with a comparison to the previous year.~~

~~6.Identification of the third party sources used for evaluation with complete contact information provided to facilitate direct contact by countries with those sources.~~

~~7.A copy of this Policy with procedures and a timetable for how countries or interested parties can bring forth comments or new information.~~

~~B. The CalPERS Board shall make this annual report available for public inspection through the CalPERS web site or its own direct distribution at its discretion.~~

~~C. Annual Timetable for Reporting and Public Comment~~

~~1. An exposure draft of the annual report shall be provided for submission to CalPERS by January 31st, or the first business day after January 31st if that date should fall on a weekend.~~

~~2. The draft report shall be placed on CalPERS' web site and a copy of said draft report shall be sent to the Washington, DC embassy of each evaluated country and to the head of each country's primary stock exchange.~~

~~3. Countries and other interested parties shall have 30 days to review the report and provide feedback or additional information to be considered.~~

~~4. CalPERS' third party sources shall then have 30 days to review any new information that has been submitted in a timely manner for independent verification and vetting.~~

~~5. At the February Investment Committee meeting, the draft report shall be presented as an information item. An interim posting at the March Investment Committee meeting shall be provided, and formal adoption of final recommendation shall occur at the April Investment Committee meeting of each calendar year.~~

~~6. The CalPERS Board reserves the right to modify this timetable in its sole discretion from one annual evaluation to the next.~~

~~IX. PERMISSIBLE EQUITY LIST~~

~~A. Country markets can only be included on the list of permissible countries for investment after an adoption of a resolution by the CalPERS Board at a publicly-noticed Investment Committee meeting. Inclusion on the list of permissible countries does not compel CalPERS actually to commit assets to that country's equity market if in its sole discretion it is not considered economically attractive to do so. CalPERS may at its discretion delegate that decision to either its Staff or external money managers as they may be employed.~~

~~B. Countries, conversely, can only be removed from the list of permissible countries in a similar manner, by adoption of a resolution. If investments in~~

~~a country's public equity market exist at the time of a resolution to eliminate that country from investment the CalPERS Board shall direct the manner of divestment in its sole discretion, which may include the acceptance of a recommendation from its Staff or General Pension Consultant on the best approach to divestment.~~

X. ~~CURE PERIOD~~

~~A. Cure Period The CalPERS Board in its discretion may grant a country a cure period of up to one year before a decision to remove that country from the permissible list of investments is made. In the event that the CalPERS Board in its sole discretion grants a cure period, the following procedures shall apply:~~

~~1. Countries that are granted a cure period by resolution of the CalPERS Board at a publicly noticed Investment Committee meeting, shall be notified formally by the General Pension Consultant after the Investment Committee meeting in April of the year in question. Notification will be sent to the Washington DC embassy of the affected country and the head of its principal stock exchange.~~

~~B. The notification shall include a procedure document that must be followed. The procedures shall include:~~

~~1. A referral to the third party sources CalPERS uses for the analysis.~~

~~2. The timeline that is to be strictly adhered to for the country's response.~~

~~3. The need to formally notify the General Pension Consultant and CalPERS of the intent to challenge or comment on the preliminary report.~~

~~4. The requirement to include written evidence or support to back up the claim made that challenges the preliminary report that shall be sent simultaneously to the General Pension Consultant and the appropriate third party sources.~~

~~5. The requirement of the challenger or commenter or its agents to meet with any appropriate third party source before the end of the cure period, i.e. before February 28th of the following year of the year in question, allowing sufficient time for the third party source to vet the information that is provided from the meeting(s) by the February 28th deadline. In the event a third party source believes that it has insufficient time to vet the challenge or the new information provided, it shall immediately notify the General Pension Consultant who shall inform CalPERS at its March Investment Committee~~

meeting. The CalPERS' Investment Committee can determine in its discretion to grant more time or adhere to the stated schedule.

6. The cure period shall end as of March 31st of the following calendar year for the resubmission to and vote of the Investment Committee at its April meeting.

Adopted by the Investment Committee: October 18, 2004

Revised by the Policy Subcommittee: September 16, 2005

Adopted by the Investment Committee: October 17, 2005

Revised by the Policy Subcommittee: February 20, 2007

Adopted by the Investment Committee: March 12, 2007

Revised by the Policy Subcommittee: April 13, 2007

Adopted by the Investment Committee: May 14, 2007

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SUPPLEMENT TO
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FOR
PERMISSIBLE EQUITY FOR EMERGING EQUITY MARKETS~~

~~EQUITIES IN NON-PERMISSIBLE MARKETS~~

~~External Managers may invest in select public equities in non-permissible markets in accordance with the following requirements:~~

- ~~A. Only External Managers who manage equity emerging markets only portfolios for CalPERS are eligible to invest in equities in non-permissible markets.~~
- ~~B. Investments in securities of companies that conduct business in Sudan are prohibited, consistent with other CalPERS policy and California state legislation. A list of such companies will be provided by CalPERS staff.~~
- ~~C. Eligible External Managers who wish to invest in public equity securities in a non-permissible market, whether locally traded shares, shares traded on a developed market exchange, or American or Global Depository Receipts, must provide a report for each such security, as follows:
 - ~~1. The report must address those country factors and market factors where the country of domicile possesses a score below 2.0. The report must explain why the particulars of the individual company investment overcame the factors for which the country failed.~~
 - ~~2. The report must address each geopolitical and investability factor used for CalPERS investments in permissible equity markets.~~~~
- ~~D. The External Manager shall provide each report to Staff and the General Pension Consultant on a quarterly basis, six weeks after each calendar quarter end.~~
- ~~E. The External Manager shall provide each report to the Investment Committee annually, coincident with the annual company reporting by the emerging markets managers. The Manager shall address questions from the Investment Committee during the meeting at which the reports are presented.~~

~~This policy is consistent with CalPERS' commitment to the United Nations Principles for Responsible Investment. It shows that CalPERS is acting in the best interest of our beneficiaries by incorporating environment, social and related issues into investment analysis and decision-making processes, when consistent with CalPERS' fiduciary duty.~~